PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

October 1, 1985

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, October 1, 1985, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Balles
Mr. Black
Mr. Forrestal
Mr. Keehn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger
Mr. Wallich

Mr. Guffey, Mrs. Horn, Messrs. Melzer and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, 1/ Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, 1/ Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Broaddus,1/ R. Davis,1/ Kohn,1/ Lindsey,1/ Prell,1/ Scheld,1/ and Ms. Tschinkel,1/ Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. Cross, Manager for Foreign Operations, System Open Market Account

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1/ Entered meeting after action to ratify foreign currency transactions.

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Promisel,1/ Senior Associate Director, Division of International Finance, Board of Governors
Mr. Gemmill,1/ Staff Adviser, Division of International Finance, Board of Governors
Mrs. Low,1/ Open Market Secretariat Assistant, Board of Governors

Messrs. T. Davis,1/ Lang,1/ Ms. Munnell,1/ and Mr. Rolnick,1/ Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, Boston, and Minneapolis, respectively

Messrs. Burger,1/ Pearce,1/ and Scadding,1/ Vice Presidents, Federal Reserve Banks of St. Louis, Dallas, and San Francisco, respectively

Mr. Sniderman,1/ Assistant Vice President, Federal Reserve Bank of Cleveland

Ms. Meulendyke,1/ Manager, Securities Department, Federal Reserve Bank of New York

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1/ Entered meeting after action to ratify foreign currency transactions.

Transcript of Federal Open Market Committee Meeting of
October 1, 1985

[Secretary's Note: This meeting began with an executive session that was not recorded. Also not recorded were the Committee's approval of the minutes of the previous meeting and the foreign currency transactions undertaken over the intermeeting interval. The report by Mr. Cross, Manager for Foreign Operations, was presented during the executive session and is included in the Appendix.]

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. They all got unwound in an orderly way?

MR. STERNLIGHT. Those extra loans were unwound, yes sir.

CHAIRMAN VOLCKER. Any comments or questions? We need to ratify the transactions.

VICE CHAIRMAN CORRIGAN. So moved.

CHAIRMAN VOLCKER. Without objection. Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Where is the dollar today, roughly, compared with the second-quarter average?

MR. TRUMAN. Down about 12 percent.

CHAIRMAN VOLCKER. Any other questions or comments?

MR. BALLES. I just wanted to make sure of what I heard, Jim. For the projection of the dollar, you assumed down 20 percent by the end of 1986 from where?

MR. KICHLINE. The Q2-1985 average.

CHAIRMAN VOLCKER. From which you've already had a 12 percent decline?

MR. KICHLINE. Correct.

MR. PARTEE. So it's about the same rate of decline as previously.

MR. TRUMAN. From now on out. I think that really is an accident.

MS. SEGER. What did you think of the NABE forecast of a recession late next year or early 1987, since they're having their annual convention right now?

MR. KICHLINE. Well, I guess it's somewhat fortunate that we don't have to forecast into 1987 at the moment. It's rather cloudy, I think, in terms of trying to look into late '86 and '87. There are questions about lots of things. What do you assume about policy and the dollar? One of the things that is happening--and I can lay this on Ted in the sense the dollar forecast is giving us some help--is that as we go on into '86, if the dollar follows the path that we've assumed, we ought to be getting some benefits from that domestically in terms of increased production. So, at this moment I wouldn't necessarily come up with a bearish forecast and assume that the economy comes to a grinding halt in late '86 and early '87. Certainly, our forecast as we have it now would not give one the sense that we begin Q1 1987 and fall off a cliff; we have a sense of the economy growing in the 2-1/2 to 3 percent area pretty much throughout the period, but being helped by the foreign trade sector later on in 1986.

MR. BALLES. May I follow up on this dollar outlook question because that's a very key one? If I understand your numbers correctly, your expectation is that the dollar will be down another 8 percent between now and the end of '86. It's already down 12 percent from the second quarter of '85.

MR. TRUMAN. Another way of looking at it, as Jim said, is that this forecast is built on the assumption that in the 4th quarter of 1986 the dollar will be 5 percent lower than in the last forecast. And most of that downward adjustment occurred between the time of the August meeting and today.

MR. KICHLINE. Previously, the assumption had been a very gradual decline throughout the period; this assumption is essentially front-loaded in September so that we would anticipate a bigger impact on the economy in terms of exports, imports, and prices than we had earlier because it doesn't occur very gradually throughout the whole period.

MR. BALLES. Thank you, Jim.

CHAIRMAN VOLCKER. No more questions or comments on the business situation? If not, we'll turn to Mr. Axilrod.

MR. PARTEE. There aren't any comments on the business situation?

CHAIRMAN VOLCKER. Well, I assume that they're going to come later.

MR. AXILROD. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Now, who would like to comment? We've run out of staff; it's up to the Committee.

MR. BALLES. I would like to ask for a little further clarification in Steve's view of these so-called portfolio shifts as a possible partial explanation of the surge in M1. Looking back to May, as we all know, we have seen absolute declines in some of these term deposits like large-time deposits, term RPs, term Eurodollars, etc. You and your staff study this, Steve. To what extent is that a significant factor in this surge in M1?

MR. AXILROD. Well, we think it's largely behind the strength of the NOW accounts over the past several months--that is, the strength above what "normally" occurs. At the same time, of course, we have had large increases in old M1A, the currency and demand deposits component. It's conceivable that some of that money could be flowing into demand deposits, but I don't think much. Or it could be flowing in for a very few days as people make up their minds what to do with it. So I'd say it has been a strong element, but I can't put a percentage on it. I'd say it's not 80 or 90 percent dominant, but maybe a little less than that. From June to September, for example, old M1A moved [up] around 8 percent while the present M1 grew 13.7 percent. It's not as if it's all in the NOW accounts; a substantial part is in currency and demand deposits.

MR. BALLES. Well, that's what I recall. In the May-to-August period, which is what I was looking at, the increase in demand deposits was just about as big as the sum of the increase in NOWs and Super NOWs. So, I'm a little confused as to whether the portfolio shift out of these term deposits was in fact directly connected with the rise in old M1A.

MR. AXILROD. Oh, I doubt that it's very much in there. I could conceive of some going into demand deposits for a while but not for very long.

MR. BALLES. Yes, that's about my view.

MR. PARTEE. Why would you take money out of an interest-bearing deposit and put it in a demand deposit? That's--

MR. AXILROD. Yes. I would say that it's only conceivable for a transitional period while one is making up one's mind what to do with it.

MR. PARTEE. Very short.

MR. AXILROD. That's why it could affect the average for a very short while.

MR. PARTEE. And currency has gone up quite a bit too.

MR. AXILROD. Well, it has. It has its ups and downs.

MR. PARTEE. I know.

MR. AXILROD. But starting in May, we had growth rates in three months that were 10 percent or more and in two months that were 6-1/2 percent. It's on average a little faster, but I don't think it's extremely noticeable.

MR. BOEHNE. Well, one could make a case that we're seeing some backsliding in the demand for money. If you think about the increases in velocity over the last 30 years and the various reasons for that--higher rates, inflation, increased use of credit cards for cash--now we're finding less inflation and more of M1 bears interest. There could be some backsliding in a number of local markets. Credit cards aren't what they used to be; service charges are being applied from the date of purchase rather than giving that grace period of a month. It's nothing we can measure very precisely, but it seems to me that in the '80s there has been some backtracking in the very same kinds of forces that led to an economizing of money in the '60s and '70s. And there just could be some backsliding.

CHAIRMAN VOLCKER. I don't know about the credit card explanation but I have a couple of charts in front of me depicting just a very simple part of velocity, M1 velocity, with various lines. And it just stands out in these charts that--well, just how it looks depends upon the lag--there has been a flatness or a downward tilt for four years now. This chart shows a break in trend, not just this year, or not just in '83. It has been flat for four years.

MR. PARTEE. The same period that we've had a very rapid increase in credit relative to GNP.

MR. AXILROD. The same period--

CHAIRMAN VOLCKER. Well, this began before that I think, but I don't know what the connection is.

MR. PARTEE. Did it? In 1982? I don't [know] either.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Mr. Chairman, I'd like to make two comments. One is that we have been seeing, really since the beginning of the year, a divergence between the growth rate of M1 and the growth rates of all of the broader aggregates. If you look at total liquid assets, debt, M3, and even M2, you'll see a deceleration in growth rates since early in the year. M1 is the only one on the chart that we show accelerating. I wonder if you would look back in earlier history, Steve, and find the periods where we had this kind of divergence in the past. I don't think there were very many, actually. But given that divergence, what weight should we apply to the M1?

MR. AXILROD. That's the exercise we engaged in, actually. This was a three-quarter period of an acceleration--these are accelerations not levels of growth rates--in M1 that has occurred through the third quarter of this year; it's an acceleration of 9 percentage points, essentially, at an annual rate. At the same time the nontransactions component of M2 has decelerated by 3 points. And M2 itself measured over the same period [decelerated] by about two tenths; it certainly has not accelerated. Now, when we looked back, the other period of exception in some sense was back in the first quarter of 1966. Then the nontransactions component dropped 1 percent and M2 went up 1 percent--small increases relative to M1, which had gone up 4-1/2 percent. There were some other periods where there were similar drops in the nontransactions component and small increases in M2. In a couple of them money and nominal GNP went up together. But by and large where M1 has been strong and nominal GNP has been correspondingly strong, M2 also has been relatively strong. And the only thing I can make out of that is that we were getting shifts into M1 and out of the nontransactions component of M2, which doesn't affect M2 as a whole but does affect M1. And in that case, M2 might be given some weight because of the conflict of the two; and it was tending to say that nominal GNP isn't going to move quite as much. The simplistic formula would be that if M1 is strong and M2 is strong, the odds are better that nominal GNP is going to go up than if there are conflicts between the two [aggregates]. And I think that's--

CHAIRMAN VOLCKER. You didn't look beyond M2?

MR. AXILROD. Well, I have a whole list of variables here, like the rate of change in commodity prices, the dollar. None of them worked--

CHAIRMAN VOLCKER. You didn't look at M3 and liquidity and debt?

MR. AXILROD. I have, yes. I have the nontransactions component of M3, but not M3 itself. And that doesn't do very much for you. I have debt as a whole here. And that isn't consistent enough; it has scattered minuses and pluses.

CHAIRMAN VOLCKER. Mr. Black.

MR. MORRIS. I have another point, Mr. Chairman. I'd like to propose that a presentation be made by the staff at some future meeting on this whole issue that Steve raised in his presentation of what we're going to do if we're faced with a precipitous decline in the dollar. To what extent do we let the pressure be borne by the exchange rate and to what extent do we let it be borne by interest rates? It seems to me it would be helpful, if we get to that point, to have had a thorough thrashing out of what all of the consequences would be. I could tell you that my own bias at the moment would be to have a policy geared to letting the exchange rate take the pressure. But I'd like to be better educated on that subject.

CHAIRMAN VOLCKER. We may need some.

MR. AXILROD. We have some work in process.

MR. PARTEE. Well, is it the exchange rate versus interest rates or is it interest rates versus prices?

CHAIRMAN VOLCKER. Well, why don't you just review this little frightening exercise you did yesterday, Mr. Truman.

MR. TRUMAN. I have a paper here to look at. With much hesitation, we have run estimates--with the help of models, rules of thumbs, judgments--and looked at what would happen if we had a 40 percent decline in the dollar over a very short period--18 months, roughly.

VICE CHAIRMAN CORRIGAN. That was 40 percent you said, Ted?

MR. TRUMAN. Yes, 40. [The specific number] doesn't matter; basically, it's a very large decline over a short period of time. And then we looked at where the economy would be three years later--another 18 months after this decline had happened. We looked at two extreme assumptions: one was that you don't change money growth, or at least what the models tell you money growth is; and the other was that you don't let interest rates change. In the first case the models tend to tell you that the nominal GNP won't change at all.

CHAIRMAN VOLCKER. The first case meaning let interest rates go up but--

MR. TRUMAN. Let interest rates go up; take it on interest rates.

CHAIRMAN VOLCKER. That's your extreme assumption?

MR. TRUMAN. That's an extreme.

MR. PARTEE. Very extreme.

MR. TRUMAN. The level of real GNP, while it may go up initially, comes back down as the interest rates--

CHAIRMAN VOLCKER. It doesn't go up beyond what it otherwise would.

MR. TRUMAN. Right. But the composition changes because gross domestic purchases go down by about 5 percent. That is about enough to change--well, it gives you $140 billion on the current account and essentially wipes out the current account deficit. So, gross GNP is unchanged, gross domestic purchases go down by about 5 percent, making--

CHAIRMAN VOLCKER. From what they would otherwise have been.

MR. TRUMAN. From what they would otherwise have been, yes sir.

MR. PARTEE. And prices?

MR. TRUMAN. And the price level goes up by 7 percent.

SPEAKER(?). Seven?

MR. PARTEE. Above what it would otherwise go up.

MR. TRUMAN. Above what it would have gone up. At the other extreme, real GNP goes up by around 10 percent compared to what it otherwise would be. Gross domestic purchases, since you have a sympathetic effect from the addition to net exports, go up above what they otherwise would be. Capacity utilization you might not believe: that goes up by 6 percentage points. The unemployment rate drops by a somewhat unbelievable 3 percentage points. The consumer price level goes up a total of 12 percentage points. Governor Partee commented that he didn't believe that number would be so small; I think I agree with him. And because you have these sympathetic--or unsympathetic--income effects, you get half as much mileage on the current account deficit.

CHAIRMAN VOLCKER. I don't want to get involved with the particular numbers, but what these exercises illustrate is that if you take extreme--I hope extreme--assumptions and you're going to correct that $150 billion current account deficit, you have a helluva relocation from domestic consumption to the external sector. You would have what's going on in Latin America where they have had no increase in domestic consumption while they are putting all [their expanding production] in exports. And unless events force some of it out of domestic consumption, you have a helluva inflationary impact and capacity problems and employment goes up and unemployment goes way down.

MR. AXILROD. From another perspective, Mr. Chairman--and this supplements Mr. Truman's data--we've been working on this also, partly using the quarterly model and partly using some judgment. And with the same assumption that we get the current account balanced, the question is whether interest rates go up and whether it reduces fixed investment and all that. But the model ended up with a very high personal saving rate in that process, which we judgmentally reduced over a four-year period. By the time it was all done we were ending up with a personal saving rate of very close to 8 percent which, as you know, is very high historically. That sort of cast into doubt the practicality of all this short of other measures, such as a weakening economy, which themselves would bring the current account in balance. And that same exercise, to verify it in the sense of capacity, did require capacity utilization rates in manufacturing rising--depending on [an assumption of potential] capacity growth on the order of 2-1/2 to 3 percent--to the area of 85 to 87 percent. If you thought [potential growth] was 3-1/2 percent, it'd be a little lower than that. But it certainly is on the order of 5 percentage points added--

CHAIRMAN VOLCKER. In your little exercise where you kept the GNP where it otherwise would have been, Mr. Truman, what kind of interest rates did you get?

MR. TRUMAN. They go up initially, as Steve was commenting earlier, but then they come back down as they begin to bite or constrain the economy. I think at the peak these exercises generated [rate increases of] something like 500 or 600 basis points.

MR. PARTEE. You have to cut the domestic demand 5 percentage points. That's a lot.

CHAIRMAN VOLCKER. Well, I think--

MR. BOEHNE. But on the other hand, why would you want to cut demand all that much? Where we have a lot of excess capacity is in the manufacturing sector and that's just exactly where you would have the substitution with imports. So it would seem that while we'd have to rearrange domestic consumption, reallocate it somewhat, we still do have a lot of excess capacity concentrated just where we need it because it's largely manufactured goods that we are importing.

CHAIRMAN VOLCKER. Well, you see more of that excess capacity, I think, than I do. It's arbitrary.

MR. BOEHNE. Well, I could take you on a trip through parts of Pennsylvania where they claim they have a heck of a lot of excess capacity. If they had the demand for some of these manufactured goods that they say are now [being imported] from abroad rather than being produced here--

MR. PARTEE. Ed, if you give those people income they're not just going to spend it on products, they're going to spend it on services too.

MR. BOEHNE. I understand that.

MR. PARTEE. And there is a macro effect.

MR. BOEHNE. I understand that. My only point is that we don't have to be anywhere near the extreme of this; we can be somewhere in the middle. And we might be able to be on the side of the middle that gives us a little more growth largely because of where this [capacity] is. We have areas in Pennsylvania where unemployment is 10 to 12 percent. These are largely people who have been displaced by the imports.

MR. KEEHN. I raise the same question on the capacity. For example, the automobile industry domestically is operating about flat out currently. They are trying to speed up their lines and they are adding shifts. But fundamentally, the people I've talked to are saying that never again will they add another dollar's worth of capacity on the domestic side. If there is any shift, they will begin to bring in more products from Mexico and Korea. They are not going to add to their capacity. So, I think there are an awful lot of industries that have quietly--and some not so quietly--taken capacity off the line. So, if we get a resurgence of demand for domestic output, the capacity would really--

CHAIRMAN VOLCKER. I would note that our trade deficit, largely in manufactured goods, is the equivalent of something like 16 to 17 percent of manufacturing output.

MR. MORRIS. So I guess the only thing we can do is pray for a gradual adjustment.

CHAIRMAN VOLCKER. That's probably right.

MR. MORRIS. Either that or we're in trouble either way.

CHAIRMAN VOLCKER. Well, we're in trouble politically the way things are now and I think it's unsustainable. That's a pretty good definition of trouble in terms of the overall performance of the economy, employment--

MR. STERN. That was based on a radical assumption about the dollar. I would like a little elaboration from Steve or from Ted as to how market participants have viewed the G-5 announcement so far.

MR. AXILROD. Well, I could add that one example we were working out would imply the dollar would go down, but I don't know by how much. But suppose you said you're going to move to current account balance over a four-year period--and this is relevant to what Mr. Boehne was mentioning in a lot of ways. Just say you're going to do that, but if you do it you've got to press. So, apart from what happens to the dollar, you have to have over that period gross domestic purchases--consumption plus investment plus government expenditures--growing less than GNP. And there has not been a four-year period [like that] in the postwar period. There have been some periods where it has grown less but not [for so long]. On one estimate we've worked out, if you went to current account balance and GNP was growing 3 percent in real terms--yes, your potential may be a little more because you had a little slack in unemployment--you would have had to had gross domestic purchases growing 2 percent over that four-year period. So, it's 1 percentage point less year after year.

The public has to be willing to sacrifice output, in effect, to abroad.

CHAIRMAN VOLCKER. Not sacrifice output.

MR. AXILROD. I mean to sacrifice their consumption relative to output.

CHAIRMAN VOLCKER. Which could most logically come by cutting the federal budget deficit.

MR. AXILROD. Yes. To make it difficult, we were assuming that didn't happen. That's not the experience of the postwar period. It has been less than that, but not for so long. I don't think--and Mr. Cross and Mr. Truman [may think differently]--that the market has yet moved to the point where they think the dollar is going to drop 40 percent. But that's the danger, I think.

MR. CROSS. I imagine it would be falling a lot sharper if the market thought that.

MR. AXILROD. Yes.

MR. BLACK. Could you supply us with a written statement of these simulations you ran so that we could take a look at them at a more leisurely pace?

CHAIRMAN VOLCKER. Why don't we have a little presentation at the next meeting? I hope that's not too late. But I think these issues are clearly at the heart of our problem.

MR. PARTEE. Yes.

CHAIRMAN VOLCKER. We have a disequilibrium in the economy. How do we correct it? Frankly, how to correct it--to produce a nice smooth correction--is not all within our power, I'm afraid. There are certain extraneous forces that are going to foul us up. Well, I think we better have a doughnut after this.

[Coffee break]

CHAIRMAN VOLCKER. I think our discussion [about the exchange value of the dollar] needs further elaboration, because the problem is evident in what was said. The success of countries in the past of pushing their own currencies down without creating problems is extremely limited. In fact, I don't know of any case where any country has done this and been happy about the end result. Just to sharpen the dilemmas a bit, the funds rate has been up the last couple of days over the course of the [quarter-end] statement date. Ordinarily, we would think that [rise] would have a strengthening effect on the dollar; the dollar is weakening quite a lot today. The latest money supply figures are down rather significantly, so the possibility of a minus in October is not remote, given the [September] average that we start with. These are very fragmentary data; I hate to even mention them on this unfortunate day, Tuesday, when we get this fragmentary information. [The weakness] may loom larger tomorrow and remain. We do not have a weekly figure but a fragmentary indication of a weekly figure. But September looks lower than was projected and October may be starting lower.

MR. PARTEE. That's surprising. With September growth I presume at least 10 percent, I would think that the end of September would be higher than the average for September.

MR. AXILROD. We had projected about equal, given the ups and downs in the month. The latest figure would suggest that the month-end is quite a lot lower; but that figure revises.

CHAIRMAN VOLCKER. September started higher.

MR. AXILROD. It started quite high.

CHAIRMAN VOLCKER. Well, there hasn't been much discussion of the straightforward business scene or the inflationary scene or anything else while we, I think usefully, were preoccupied with the basic [dollar] adjustment problem. I think we can proceed and go around the table. Mr. Black.

MR. BLACK. Mr. Chairman, I held up my hand right before we got into the discussion of these foreign exchange simulations and we were trying to grapple with the idea of what accounts for the strength of M1. Everybody has been searching for that, even those of us in Richmond who don't always take that [aggregate] completely at face value, as you may assume we do. I guess we reached the conclusion that this had to spell trouble for us unless one of two things has happened. One would be that there has been a downward shift in the long-term trend of velocity--and I think there probably has been something of that as a result of financial innovation. But it seems to me unlikely that this decline in velocity will be of such a magnitude that we can stand growth of anything like the 10 to 12 percent we have had over the bulk of this year without running into problems. The second way in which it would not be inflationary would be if these sharp drops in nominal rates have been accompanied by a corresponding decline in either inflationary expectations or the real interest rate as a result of some autonomous weakening in some part of aggregate demand. Actually, what little information we have on inflationary expectations suggests that there really hasn't been much of this. One can't rule out these two possibilities at all, but on balance it seems to me that these two explanations--if indeed they are the only two, as we think they are--are insufficient to justify [M1] expansion of anything like what we have had. So, we need to do something to get back to more normal growth rates. It may be, as you said, that we are going to do that without any effort on our part. But I do think that it is imperative that we slow this down to some extent because we just cannot explain away that much growth, in our judgment. When we get to specific policy points, I would be glad to make some later; but I sense that it's probably not the best time to do it now.

CHAIRMAN VOLCKER. Well, time is passing, so if you want to be more specific, you can.

MR. BLACK. Well, I would think that it is important that we go ahead and move the borrowed reserve target up some. This may prove to be totally unnecessary, but I would think something like $650 to

$750 million would be appropriate. That might, of course, cause some increase in the federal funds rate--to 8-1/2 percent or so. If [money] is still growing fast, I would be prepared to accept that. If it isn't, then I would want to back off from it. But I don't think that we ought to be so over-zealous in our efforts to get the money supply back on target that we aim even at the top of the range that we revised at midyear. I think that clearly would be overkill in view of the rapid expansion we have had thus far. But something like this 8 percent quarterly rate that is projected for the third quarter would seem to me to be reasonable in light of the kind of growth we had before the second quarter.

MR. PARTEE. The third quarter is pretty well determined. Are you talking about alternative C--5-1/2 percent for September to December?

MR. BLACK. Well, I am talking about the quarterly rate.

MR. PARTEE. On the quarterly, it's that high from the 3rd to the 4th quarter.

MR. BLACK. The third quarter--if I don't have my figures wrong--would be about 8 percent. It's 8 point something or other--8.3 percent. I am just talking about the quarterly rate there.

CHAIRMAN VOLCKER. These new numbers, if they stand up, will reduce September by about 2 percentage points or more.

MR. BLACK. Of course with our procedures, we always have a risk that we are not going to get what we think because there's a pretty loose connection between the rate of growth in any of the aggregates and the borrowed reserve target.

CHAIRMAN VOLCKER. I think we can stipulate that.

MR. BLACK. But I think we maybe ought to err a little on the side of tightness to make sure that we get some progress toward decelerating M1. But I would not push it so terribly hard that we get into--

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, looking at the general business situation, I have changed my forecast very little from the last meeting. I think we are beginning to see the kind of numbers we hoped for and that we wanted to see. I feel more confident about the economic situation than I did a month ago, and I find that that impression is shared pretty much around my District by the business people I talked with. There seems to be much less uncertainty about the course of events. The people I talked to are seeing some forward momentum in the economy that they think is going to carry over into the fourth quarter and, indeed, into the first half of 1986. Now, that view of the economy may be influenced a little by conditions in the Southeast, which are relatively better I guess than in some other parts of the country. While we have some weaknesses, particularly in export-related areas such as textiles and so on, those weaknesses are being offset by strengths otherwise.

On the aggregate picture, I would agree pretty much with the forecast of the Greenbook, although on the composition of that forecast I would differ marginally. I would think that perhaps we are going to have a little less strength in housing than in the Greenbook, but otherwise I am generally in accord. I think consumer spending is a real question mark here. My staff is telling me that they expect consumer spending to increase, especially in durables. I am not sure that that's a correct assessment, given the high debt level and the personal income situation that we have.

CHAIRMAN VOLCKER. And a very low saving rate.

MR. FORRESTAL. A very low saving rate as well. The inflation picture looks pretty good. Everyone I have talked to doesn't see any price pressures at all. There are certainly no wage pressures in my area. Altogether, I think that the situation, while not dramatically great, is certainly better than it has been. And I think the outlook is reasonably favorable for the economy to grow at about the trend rate of 2 to 3 percent for the year as a whole.

As far as monetary policy is concerned, we have all of these imbalances that we talked about considerably this morning and I don't think that there is very much we can do about those imbalances. So my feeling, Mr. Chairman, is that we should stay pretty much where we are in terms of policy. The dollar, of course, is something that we obviously will want to watch very carefully. If there were extreme changes in the value of the dollar one way or the other, I think that we ought to move aggressively. But as I see the picture at the moment--given the economic growth, the declining dollar, and the absence of inflation [pressures]--I would stay where we are. I guess that means alternative B, although that perhaps suggests a slight uptick in market conditions. M1 is a lingering concern; I am nervous about that. On the other hand, I wouldn't take any positive action to try to bring its growth down appreciably. I hope it will come down on its own accord in October. But particularly in light of what has happened in the G-5 meetings, I don't think we ought to be doing anything to run interest rates up. In terms of the specifics, I would stay about where we are, maybe about $450 to $550 million in borrowing and that probably means a federal funds rate of 7-7/8 or 8 percent. I don't think it makes a lot of difference which of those we come out with. Just to complete the specifics: On the question of the variants, I would like to use variant I.

CHAIRMAN VOLCKER. Just in terms of the discussion, I think we should leave that until the last because, on the face of it, that's not substantive. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Just a brief comment on the business situation: My own view is similar to Mr. Forrestal's in that I do draw more encouragement from the collection of latest statistics--not that they lead to anything different than the staff forecast, but I think that they raise the chances that that, or maybe a tad better, in fact is what will happen. But I must say that in and around New York City anyway, the people associated with the very large multinational companies [unintelligible], notwithstanding the recent business statistics, are still very distinctly on the bearish side of things. I am not quite sure whether that's just a further manifestation of the way in which those companies are being affected by the external side.

There may be some of that, but I detect in the time frame of the past six weeks or so a higher level of concern in that community about the underlying policy situation. There is even, as I said before, some whispering to the effect that sooner or later that underlying policy situation is going to lead to more inflation--not that anybody sees it right now, but that there's a sense of inevitability about it.

CHAIRMAN VOLCKER. Some of them may even want it.

VICE CHAIRMAN CORRIGAN. I think that's true. But again, I think the combination of things, including realization of a budget resolution and all of the rest, has given rise to a renewed sense of cynicism if not outright hopelessness in terms of the budget situation. And in terms of monetary policy, there is a sense that the constraints are growing--constraints in terms of financial fragility, of the M1 problem that everybody wants to pretend isn't there but can't quite get themselves to pretend that it's not there, and more recently a net feeling that this G-5 [agreement] works in the direction, at least in the short run, of more of a constraint on policy. As I said, it's hard to judge that; but I think more attention has been paid to the policy dilemma in that segment of the business community in the recent past than I, at least, had detected earlier. Now strangely enough, attitudes outside of that community of the Fortune 500, including even places like Buffalo and Rochester, are distinctly better. I can't quite figure out why that's true, but we have had a couple of meetings upstate recently and I was really struck by the very sharp difference in perceptions about the business situation, even in the Buffalo area. We have an auto worker, and he's dancing in the aisles. He is not buying this notion that all of this [improvement in the] auto situation recently is just financing-related. He seems to think that they are really getting back into a groove. That's strange, but true.

MR. PARTEE. It certainly would be desirable for him.

CHAIRMAN VOLCKER. You have the vote protecting money?

VICE CHAIRMAN CORRIGAN. I don't know if it has quite progressed to that point. It wasn't just either. I was amazed at the attitude among a group of about 25 business people up there two weeks ago. It floored me. I thought I was back in Minneapolis, Gary. Anyway, extracting from the vagaries of the business situation, however one judges it, my own view on policy is that we should stay where we are, which means alternative B pretty much as sketched out in the Bluebook. In the immediate here-and-now situation, on top of all of vulnerabilities that have been there all along, I must say that I personally think the major vulnerability is a downside break in the dollar in the near term. I am not predicting that, but I think the risks are there. I am not sure what one does about it, but I would be prepared to tilt the thrust of policy in the context of alternative B in the direction of trying to mitigate against that vulnerability in any little way that we can.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I note that much of the positive news recently has to do with housing sales and the leading indicators. When you take autos out of consumer spending and analyze the [rise in the] leading indicators, which has been in the financial [components] up until the very last month, I am not sure that there has been such a turn in the leading indicators as to point to much more strength in the period we are going through. I note and support the Fed staff revising the growth downward in some of their projections at least. It seems to me that when the labor force resumes its growth, we well could have that two- or three-tenths improvement [in the unemployment rate] disappear, as I think Jim hinted at. As the labor force resumes growth and we remain on a 2 percent [real GNP] growth line rather than 2.7 or 3 percent or whatever, unemployment could well begin to creep up again, given the continued layoff news. It seems to me that protectionist tendencies are obvious in the Congress. The price situation already has been alluded to: wholesale prices, the CPI, and the deflator are all looking reasonably good. Commodity prices generally are down. OPEC and the Saudis are having their [annual] charade. When you look at the revised third-quarter data, you find that CCC purchases are very important as are the purchases of autos by consumers. I don't get a very secure feeling about the fourth quarter on that. I note in the staff projection that while the inventory buildup, the restocking, is not the whole [explanation] for another quarter of 3 percent real growth, it is most of it. We have been disappointed, if that's the word, in the inventory buildup in recent months; we previously were projecting inventory being a [plus] factor for the third quarter. I would make the same comment about the [projection for] inventories for 1986. I think that we may be a little too positive in that. I feel we are quite optimistic in our analysis of the trade balance and how quickly that is going to help us and how quickly import prices are going to change. We are talking about changes by the second quarter of next year. So, we well could have 2 percent real growth for the fourth quarter and for the first and second quarters or perhaps for the whole year next year. Once again, that gets me to the problems of unemployment and protectionism.

In terms of monetary policy, I would go along with alternative B, but given the way the markets have perceived our policy until very recently, the funds rate has been trading down below what might be expected. Add the borrowings and the excess reserve position to the federal funds trading range and it looks as though the market really hasn't detected the slight movement toward more borrowing and slightly higher rates from the last FOMC [meeting]. Therefore, I would like to see us go back to $425 million as the starting borrowing level and to 7-1/2 to 7-3/4 percent on the federal funds rate, to give ourselves a little action space in interest rates, in case we do have the dollar giving us even more of a problem than we have already. If we have to kick the funds rate up 1/2 point, that keeps it closer to 8 percent than to 8-1/2 percent. I'd give ourselves a little space there. So, I am for alternative B, previous FOMC meeting fashion, of $425 million and 7-1/2 to 7-3/4 percent on the funds rate.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. In a broad context, certainly, our outlook for the economy would be very consistent with the forecast that Jim gave earlier in the meeting. But as has been the case, we have had in the Midwest this terrible unevenness, and that certainly has continued. Some of the areas are doing very well. We've already commented about the auto sector, but I've just been staggered by how effective the price incentive has been. It is surely causing some imbalance in sales. Nonetheless, looking ahead to next year, the people I talked to expect--and I think our forecast suggests--a very, very good auto year of, say, 10.4 to 10.6 million in sales or something like that. So the high sales level this year isn't taking too much from that. In retail sales, the people I talked with say that year-to-date sales are running 6 to 7 percent ahead of last year. That outlook looks pretty good. Looking ahead to Christmas, even though it's awfully early to see that far ahead, I think they are looking for a 4 to 5 percent increase, even though there is a shorter selling period. Commercial construction, particularly in Chicago, continues to be very, very strong. I am afraid a lot of it is tax-oriented, but buildings are going up at a pretty rapid rate. On the bad side, there is agriculture. There is nothing new I can shed on that particular problem other than to say that, as these harvests are beginning to come in, the news is very very bad; I think we are going to see a continued deterioration in that whole sector.

On the inflation front, I really continue to be very impressed by how good the news looks. The people I talked with, even those who have businesses that are doing pretty well, are negotiating contracts with annual increases as low as 2 percent, with 3 to 3-1/2 percent fairly typical for under-3-year contracts. They are getting very good changes in work rules and, therefore, have high confidence that productivity will enable them to overcome even those modest increases. And materials costs continue to be very, very tight; 1 or 2 percent increases in materials costs are pretty typical; 3 to 4 percent would be very much on the high side. So everybody I talked to is very optimistic, really, on the inflation front. All of that, of course, is excluding our comments earlier this morning.

Moving to monetary policy, it does seem to me that we are in a period when, because of the various circumstances, we have a buildup--both in terms of number and magnitude--of problems that are at the least very, very worrisome. Given that array of problems, I think frankly that we have to be very rate sensitive; I don't think that we can afford to change the status quo too much. M1 is going through an erratic period and we ought to recognize that it is very erratic. Therefore, I would be in favor of maintaining the status quo in terms of the borrowing level and the fed funds rate and I think alternative B addresses that objective. I would suggest a borrowing level of, say, $500 million and a fed funds rate at the current level without tolerating much of an increase.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Mr. Chairman, in the Fourth Federal Reserve District business conditions remain sluggish. We have price weakness across a wide range of activities; wheat, aluminum, coal, and steel come to mind on that front. Conditions are not noticeably improving and they are not really getting worse either. A bright note in our District would come from the retail side; retailers are happy with the pace of sales and they are happy with the mood of consumers. I will be very interested in assessing the reactions to the G-5 announcement in our District, since I think we are a hotbed of protectionist sentiment. I think that the G-5 announcement will be successful in blunting protectionist sentiment and that the efforts will bear fruit in a reasonable period of time. But there is an interesting twist there in that just from the very people who have the most to gain from a falling dollar we hear the concern that if it's not accompanied by either the spurring of growth abroad or the reigning in of our deficits that, in fact, it won't do them the good that they so desperately need from it.

CHAIRMAN VOLCKER. I hope you encourage that discussion.

MS. HORN. Yes, indeed. But I do think there is a real understanding in the more sophisticated business public of the dangerous game [the G-5] are playing; and we see that time and time again in our District. Having said all that, I think that if we do manage to play this dangerous game successfully and don't have a precipitous drop in the exchange rate, there is room in the short run for optimism. We have really good news on the inflation front. I don't see inflation starting from any other cause except an exchange rate decline or a real spurt in economic growth, and we may be seeing a little pickup in economic growth. So, in the short run I think there is room for optimism. I add all of that together and say that we should stay about where we are on monetary policy. That would be $500 million of borrowing and the federal funds rate where it is-- up nudging the 8 percent level.

MR. BOYKIN. Mr. Chairman, in the Eleventh District, we are probably a little more pessimistic, and certainly more pessimistic than is traditional for us. I just completed a swing around the District and found the following: in Houston, no optimism given the energy and real estate situation; in San Antonio and in Austin, a little more optimism; and in Midland Texas, where our El Paso Branch Board met--and that covers eastern New Mexico--all of the uncertainties on energy prices have them quite worried. Si mentioned agriculture. I heard one report up in the Panhandle area of cows coming out of the feed lot at a loss of $125 to $150 a head, so it's going to take a lot of volume to make that up. In Dallas, I guess there is probably a little more optimism, although I worry about it. I've talked about the commercial real estate situation to the point where you all are tired of hearing about it. But the Chamber of Commerce did a report a couple of weeks ago which said that there is more vacant office space in Dallas, Texas than there is office space in Philadelphia. And that has to be a big problem down the road.

In a broader context, my own view is that there is a little improvement in the economy. I would pretty well agree with Jim's forecast. On the policy side, I guess I have some sympathy for what Bob Black was saying; I would probably be somewhere between "B" and "C" myself.

MR. BALLES. In terms of the business situation, both around the country and around the West, it appears to us that it's a touch better than the last time we met. I would say that the risk of recession--which I never judged to be very big in any event, but it was a risk--if anything, has receded since the time of our last meeting. Having said that, there is nothing that has changed fundamentally in the fabric of the economy, certainly not in the West. We have this big contrast between things that are going well, like defense and aerospace and most services, and weakness in the fields we all know about, such as agriculture, lumber, and many lines of manufacturing.

Translating that into policy, we like many others are puzzled by the behavior of M1. The bottom line is that we, at least, can't explain it satisfactorily by any different hypothesis--that it's an increase in the demand for money and a shift in the demand function for money upward, or simply money demand moving downward along a given demand function as interest rates have come down. While you can explain some of it possibly by portfolio shifts, that does not get the whole answer either. That leaves me, net, a bit nervous about the continuing strength of M1 that we have seen and I hope that we can slow it down a little before it translates into some sort of resurgence of inflationary expectations in the market. I don't know how long market participants and investors will go along, seeing virtually an unprecedented surge in money, without beginning to wonder what lies down the road in a couple of years in terms of the inflation rate. So it is really a matter of the feedback and the impact that is having on investor expectations. So far it has been quiescent, but I wouldn't bet on that continuing too long. Were it not for the G-5 program, I would be between "B" and "C;" but given the G-5 program, I suppose the better part of wisdom is to aim for something of an even keel right now. Thus, I favor alternative B but tilting a little toward the tighter end of the specifications--going up to the maximum level of about $550 million on the borrowing range specified there and wanting to keep that federal funds rate up to about 8 percent.

MR. WALLICH. In economic terms, very little seems to have changed. Some non-economic factors have changed. As far as the situation of the exchange market is concerned, I note your fears, Mr. Chairman, but my impression is that some people in the market say that this is just another of a series of interventions that isn't going to get anywhere. They are going to wait and see what happens. If we don't follow it through, then they will just move the market back to where it was before, and we will have a defeat instead of an element of strength. That could be regarded as a reason why a softening of rates would help to support the intervention. There are other arguments on that side--the deteriorating LDC position, protectionism --but these are all very short-run developments, and what the movement of the dollar is likely to be doesn't seem to me to have much immediate influence. On the other side there are two factors that are more longer term and that do seem of concern. One is the seeming misbehavior of M1. I too make these calculations: Is it interest? Is it innovations? What can it be? Nothing seems to give an adequate explanation except the explanation that the demand curve has shifted, which it has done several times before so one shouldn't preclude it. The second is an even longer-run development. If now the dollar does go down and over time we get an improvement in the current account and we do not get an improvement in the budget, then we are building up inflationary pressures, including ultimately higher interest rates, which will be quite a negative [factor]. I think that is the most likely course of events: that we will find ourselves from meeting to meeting hoping that the current account is improving and that it will begin to improve and, meanwhile, nothing else major in the economy will have changed. I think that would be a very dangerous proposition. So unless we can get [relief] from that situation, I don't think we should put additional stimulation into the economy. But the end of all this is that I would go with alternative B because I see rather strong forces on both sides, which I can't resolve.

MR. MELZER. At the last meeting I was in favor of leaning toward somewhat greater restraint, which has since been realized. And the numbers we have gotten on the economy overall and what I am hearing in the District would tend to make one feel moderately [positive], anyway, about what is going on in the economy. On the other hand, I did not come here today with any strong feelings that greater restraint was necessarily called for. One of the reasons why I think that is the moderation we have seen in the rate of growth of money, particularly that which is expected looking forward. One thing that gave me concern immediately after the G-5 accord was the reaction of the government yield curve, specifically the coupons, where we had a steepening of the yield curve of about 10 basis points. At this juncture I would say that is something I have taken note of but at the current levels of those spreads it is not something that concerns me terribly. But I think that market, and probably to some extent the foreign exchange market as well, feels that the Fed is sitting here with its hands tied and may not be able to respond to improving numbers on the real side and rapid money growth. Because of the G-5 agreement and so forth, I don't think it would be particularly politic to consider greater restraint at this juncture; however, if things don't unfold as we expect them to with respect to lower rates of M1 growth and if we continue to get good numbers on the real side, I would certainly be leaning toward greater restraint in the intermeeting period.

I have one or two anecdotal comments. First of all, among retailers in the District there seems to be a feeling that car sales are definitely sapping the general strength of retail sales. Secondly, corroborating what Si said about inflationary expectations, I picked up the same [tenor] in a luncheon we had at the Bank: no increased inflationary pressures on costs; no perceived ability to raise prices substantially; and, to the extent that there were wage pressures, strong feelings that those could be offset with productivity gains.

CHAIRMAN VOLCKER. Let me just make an observation on this price situation. The recent figures look pretty good and promise that we will have overestimated [the rate of inflation] for the fifth consecutive year in our projections. But I don't think there is any doubt that inflationary expectations in the longer-run sense in some anemic way are increasing. The survey evidence--what we have--says that. But I feel it in my bones too that fooling around with the dollar and questions about the dollar may restrict Federal Reserve freedom of action. It tends to go in that direction. It is not an abrupt or major thing, but I think it is quite clear--just when you go out and make speeches--that people are much more open about saying that than they would have been six months ago.

MR. STERN. With regard to the business situation, I certainly recognize that one or two months don't make a trend, but I must say that I am impressed by the latest statistics. I think the economy is clearly doing better, picking up some momentum, as probably was expected by a lot of us. My own view is that we may do somewhat better than the Greenbook forecast, at least for the next several quarters. That certainly would be welcomed, other things equal, in my judgment. On the financial side, as several have mentioned, I can't quite bring myself to dismiss M1 altogether. And in any event, it seems to me that growth in the other aggregates certainly has been adequate and that liquidity in the economy is certainly ample. So, I am not sure that we are getting terribly mixed signals from the collection of statistics on that side. My major concern is that we may have a monster on our hands in the foreign exchange markets--not immediately, judging by the way things have been going, but I am concerned about the potential weakness in the dollar and the inflationary implications of that. I certainly am struck, as I travel around our District at least, by the fact that one of the origins of the problems that are evident in the District is the rapid inflation of the late '70s and early '80s; obviously, we still are suffering the hangover effects of all of that. And that is one of my principal concerns, both at the moment and looking ahead, in terms of economic performance and the thrust of policy.

For the immediate period, as far as policy is concerned, I am a little concerned that if the dollar weakens more than would seem to be appropriate or desirable, or if money growth turns out to be more rapid than we expect, we may not be in much of a position to respond to it. And what that implies to me is that, while I certainly can accept the specifications of alternative B, I would like to make one modification because of my concerns about both money growth and the dollar. And that is, I would make the borrowing range $500 to $600 million, starting at $500 but leaving us a little more leeway on the up side in case what I judge to be some of the risks here materialize.

MR. BOEHNE. I don't think a lot has changed in the economy; I think it is a touch better in my District. The feeling is generally positive, but I'd say that positive feeling is expressed in unenthusiastic words. I am struck by the disparity just in something like the unemployment rate. There are a number of areas in my District where you can find unemployment at 5 or 6 percent. You can drive 50 or 75 miles and it is 10 percent. That kind of difference is striking. On the inflation side, I would agree with what has been said: I don't think there is a real problem. Wage settlements generally have been good; however, I would point out that wages are rising, as they typically do, considerably faster in the service sector than they are in the manufacturing sector. I have been surprised at some of the increases that are planned in banking and insurance for next year in our area and particularly by the professional and managerial pay increases. So, generally I agree; but there are pockets in the service sector where we are seeing some large increases. I think the risk to the economy is largely from the financial side--the whole litany of things that we have talked about many times before at this table. On monetary policy, I don't see that we have very much room for maneuvering given the cross-currents of events, and I would find alternative B generally to be acceptable.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I agree that the business outlook looks better than it did a couple months ago. I realize you can find difficulties with all the statistics, but that is frequently true as you begin to see some strengthening. You can say that there is an oddity here and an oddity there, or it is concentrated in this or that. But in fact it is coming out quite uniformly on the stronger side. A comment was made about new car sales. Well, it seems to me that this endeavor is not costing the auto companies all that much. The present value is something under 10 percent. They have raised prices significantly, so they can very easily afford to continue to do the same thing or something similar with the '86 models. Their problem will be that they may run through a backlog of demand, not that they can't easily afford the kinds of promotions that they have been giving in this period. Also, I think technically the business situation looks better because we have a quite moderate inventory level--in fact no inventory accumulation--and good final demands. I would expect that we will see inventory accumulation and that will give us a stronger economy. Even so, the staff forecast is for 3 percent growth in the fourth quarter and on the order of 2-1/2 to 3 percent in the first half of next year. Say it runs stronger than that by a percentage point; it's still not anything excessive. So I don't see that there is an upside risk of excessive growth in the near term, and I happen to agree with NABE, Martha: I think there will be a recession by this time next year. So we are talking about a fairly short-run outlook and I don't see any reason to say that the performance of the economy looks to be such that we ought to be making financial conditions tighter than they now are by any significant amount--unless the dollar breaks very strongly or something like that, which will change the nature of things.

I note that not only has money been growing relative to GNP so that its trend looks different, but that is also true of debt relative to GNP, which is up very sharply in the last 4 years from 1.4 times GNP to 1.65 times GNP. It looks as if, for some reason that I can't quite understand, it takes both more money and more credit to keep the economy moving at all well. I think there are great pitfalls in this in the long run on the credit side; I worry about servicing the debt. That may get to be a very great problem at some point in the future. And on the money side I worry about having pumped all this liquidity in, which we won't be able to neutralize if something should touch off the desire to use it actively. But these are not questions for today; they will become perhaps very big problems later on but not for today. I think we ought to leave policy just where it is. I disagree with Pres. I don't think we ought to ease up any because I think that is something the market is looking for and would also associate with the G-5 accord and would be really more confining on us than not to do it. But I don't think we ought to tighten at all either. So I guess that's alternative B, with $500 million on borrowings as the initial estimate.

CHAIRMAN VOLCKER. I am confused about the things you are worried about: an increase in money for four years and an increase in investment for four years. When does it become timely to do something about it?

MR. PARTEE. I don't think that you can do it, if the evidence is that we have to have [such growth] in order to keep the economy moving at all well. I think you just have to live with it until the crash.

CHAIRMAN VOLCKER. Until the crash comes: a passive approach. Mr. Morris.

MR. MORRIS. Mr. Chairman, I too think that the evidence suggests that the economy is picking up a bit but I certainly don't sense in the numbers any strong forward thrust. I think it is entirely compatible with the kind of modest growth that the staff is projecting. In my area, I run into the same comments from business people that Karen did: they don't see things getting stronger; they don't see them getting weaker. I think that reflects the fact that we are a capital goods producer essentially and the weakest part of the economy right now is the capital goods sector. New orders for capital goods are no higher than they were a year ago. But I think the uptick in the economy does suggest a no-change policy. I was concerned that this might conflict with the G-5 program in the sense that I thought there was a possibility, anyway, that we would need somewhat lower interest rates to reinforce that declaration. But at least so far the evidence is that we don't; we are getting a response at current rates and I am hopeful that a nice and orderly response will continue. So I would propose no change, alternative B.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would agree with those around table who suggest that an uptick in the national economy is probably in train--that the Greenbook forecast is very reasonable. That, however, is only from a national view. From a regional view, in the Tenth District things have not gotten better; they have gotten worse. And the projections for the fall and winter, particularly in the agricultural and energy areas, hold out no great hope. As a matter of fact, the financial strain simply rolls back into the financial institutions; the outlook for banks, savings and loans, and others looks to be devastating. From strictly a national viewpoint, I would agree with those who say no change in policy. From a regional viewpoint, I guess I would have to urge perhaps some relaxation of interest rate levels. I will just note that on the inflation front, much of the contribution to stable inflation in the short run is a contribution by food and energy. And that impacts my District rather dramatically.

There has been a good deal of talk about M1 and I would agree, in view of what I have just said, that we shouldn't pay very much attention to it in the very short run. Although I would hate to give it up as a part of policy, over the next intermeeting period and perhaps over the fourth quarter as a whole I don't see M1 as a major player in policy decisions, unless other matters such as the dollar come into play and we may want to use it. On the other hand, the dollar and the G-5 arrangement are a bit puzzling to me. That is to say that there's been a great deal of talk here and I think you, Mr. Chairman, expressed the concern of a precipitous drop in the dollar. I think that is a real risk, obviously. But if you look at it in another way the fundamentals haven't changed, as far as I can see. As a result, it seems to me that the dollar has come down relative to the other currencies but I would expect that in the short run the traders will test the United States, for example, and will try to push the dollar back up to see how far the United States really will go to participate in the G-5 agreement.

So with that in mind, and with the background of the economy, particularly queuing off of my own region, I would prefer alternative B. But I am troubled a little by the language describing alternative B and that is that the staff would project a funds rate of 8 percent or a bit higher. I would object at this point, if it were up to me, to having a rate of 8 percent and pushing on up unless some of these other exogenous forces, such as the dollar, come into play. As a result, I would modify that and be someplace between "A" and "B" and start out with a borrowing level, say, of between $400 and $500 million, centering on $450 million. I am hopeful that that would be enough latitude and flexibility, if the dollar did start to drop, that there wouldn't be a [conference] call and the policy prescription changed as a result of that call.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. Many of my points have already been made, but I would just like to emphasize that I believe the risks are on the down side. The consumer spending numbers that look very robust and retail sales that look good are being supported by very generous use of credit cards and other kinds of credit. I picked up some numbers from the treasurer of one of the captive auto finance companies and the terms of auto credit really did something to me: 45 percent of their August contracts were for 60-month loans. Almost half of the contracts were for five years, which means that they needed that incentive plus a very low rate of 7.7 percent to get a monthly payment that was low enough to drag these people in off the streets. I don't read that as a terribly, terribly strong demand situation. Also, Si and I may talk to different people in the auto industry, but I haven't found anybody out there who doesn't think that this temporary burst of sales is going to be reversed, that in fact they are borrowing from the future, and that later in October we will see a very big and significant drop in sales as they pay the price for moving these '85 models out very rapidly. So I think we are going to see some distortion in the numbers here for a while that will make it very difficult to get a handle on what is really going on. But I think that there isn't as much strength basically as one might conclude. Secondly, on the housing matter, as the standards of the mortgage lenders and of the mortgage insurers are tightened, I think we are going to see that show up eventually in [a drop in] new housing starts. I admit it hasn't happened yet, but I think it will and, therefore, starts may come in a little below what the staff is now estimating. On plant and equipment spending, here again I think more and more companies are having profit problems, and that does feed back into their capital spending decisions and doesn't make them very positive about it. So, I think there may be some downside risk there.

On the inflation front, like most of the others here, I think the numbers look pretty good. I also would like to emphasize that there are sectors of the economy where there is actual deflation, which doesn't seem to get mentioned much. Also, I certainly would read the M1 numbers, but I would be much more concerned with what's going on with M1 if M2 and M3 also were going off the top of the chart, which they aren't--particularly M3. Having just met with the Decatur Chamber of Commerce yesterday and the National Association of Manufacturers, you would need to give me a bullet-proof vest if I suggested any policy change that would lead to higher interest rates or a tightening, because both of those groups are very sensitive to the financial side of the economy. They are tying that to their own problems. So I am torn between supporting "B" with a tilt toward "A" or just going straight to "A." I would be very, very concerned about any uptick in interest rates at this point for the reasons I mentioned--the impact on agriculture, the other areas that have big debt problems, and furthermore the possibility that that would undermine the recent G-5 agreement. So I guess I am somewhere between

"A" and "B" with the borrowing down to the level we were talking about at the last meeting.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I have no new observations to make that have not already been made around the table. I, too, see the economy picking up. I think that the staff forecast is right, and I particularly agree with it for the short term--that is, for the current quarter and the fourth quarter I think we'll get growth in the area of 3 percent. Given this outlook and given the other noneconomic developments that Governor Wallich referred to, I agree with those around the table who say that we really don't have much policy scope, or very much room for maneuver from a policy point of view. We certainly would not, or at least I would not, want to do anything that would reduce the chances of reaching a moderate 3 percent rate of growth. And while I would have preferred to have seen in this period after the last FOMC meeting a funds rate somewhat higher than it did in fact average and certainly less money growth, I don't think that there is anything we can do now either to tighten or to ease policy; I think that we are in a very narrow range for policy decisions. So, I think this calls for maintaining the existing degree of reserve pressure and that would be alternative B with borrowing around $500 million and the funds rate around 8 percent.

CHAIRMAN VOLCKER. Well, I don't know what I can add to all that discussion since every contingency and every threat has been mentioned by somebody. There are a lot of contingencies. In the broadest sense, we are constrained by circumstances. I wouldn't put all that much emphasis on the G-5 matter; we're constrained by more fundamental contingencies on either side. But I wouldn't interpret that too strictly in the short run. I don't know what is going to happen in a number of dimensions. A lot of people talk about the economy being a little stronger in tone. I think that's probably right, but against the background of the money supply figures in particular--Governor Partee said he could imagine [real GNP growth] going to 4 percent--I could imagine it going to a lot more than 4 percent under a certain set of circumstances. All you need is a kick in those inventories and a downward movement in the trade balance at the same time and you could get quite a little kick. I'm not sure I would predict that, but I don't think it's out of the bounds of possibility. And that makes those money supply figures look more in accordance with historical experience, and everybody has expressed uneasiness about what that means.

I do think that everybody--well, not quite everybody--but it's clear where the center of gravity lies. I don't disagree with that at all. I think the most likely risk we face--or the one I worry about the most, let me put it that way--is that the dollar may decline too far too fast and create inflationary expectations and eventually inflation. If it does pass some point of undermining confidence, it's going to be very hard to manage and it's going to produce higher interest rates. That's the real threat of a sudden drop in the dollar: decidedly higher interest rates as well as inflation. Worrying about 1/8 or 1/4 point on interest rates now will pale in significance compared to the kind of direction Mr. Truman was alluding to if those kinds of conditions ever arose. That would really throw a lot of things off course, beginning with the debt situation and recession and possibly agriculture; you name it. That's the one threat that gives me nightmares as I look ahead. For that reason, I think it's counterproductive to give any signals that we are easing at the moment. It would just create additional risks of that happening. I'm not talking about a month from now or something. If the money supply gets weaker and the economic news is weak--if we had a clear basis for easing--we should ease. I don't think we have that clear basis right now. I would also say that if we had a clear basis for tightening, we should tighten. If that arises it's going to arise, I suspect, more from the dollar side. But if we continued to get big increases in M1 combined with a real strengthening in the economy, I don't think we would have much choice, whatever the G-5 says. There are no commitments made there. But for the moment, I think we are in the area of what is loosely called "B."

I would also suggest that a certain amount of unusual maneuvering room is needed in the short run, within a narrow range, because I think a lot does depend on almost day-to-day psychology in the exchange markets. We can lean a little toward the easier side if the dollar is strong and we're having a great test on the up side, and we can lean on the other side if the dollar decline appears to be building up momentum there. At the moment that's where the momentum is, if it has any momentum. That could change any day, I well recognize. But I would come out about where most people are in terms of something like a $500 million borrowing level as a center of gravity, but I'd be prepared to go moderately above that or potentially moderately below that in day-to-day or week-to-week tactics, depending particularly upon the dollar; but as the weeks go by it also would depend upon the money supply and the economy. We are now in a period where I think within a limit--I don't know whether I'd call it $425 to $575 million or $400 to $600 million, or something in that area--we could use a little maneuverability. And I think that is consistent with a federal funds rate somewhere around 8 percent or a bit higher or lower; I'm thinking about 8 percent or a shade below 8 percent.

MR. PARTEE. The aggregates would play a relatively small role?

CHAIRMAN VOLCKER. Well, relatively small. I don't know if it's any smaller in some sense than they have been playing. I am a little influenced at the moment, inevitably, by the fact that the odds on a slowing in the aggregates look a little better to me now than they might have a week or two ago. We had a big decline last week and little change this week. There may be a sizable decline in the following week: three weeks in a row of decline. I think it's so high that I wouldn't respond immediately by easing; I would be more inclined--

MR. PARTEE. If you happen to get a negative month, say, that wouldn't cause an easing?

CHAIRMAN VOLCKER. It certainly would be a factor in saying we would be less eager to tighten if other things are pointing in that direction. It's simple if everything is pointing in the same direction. If the dollar were rebounding, with M1 softer and the economy looking rather weak, it's easy--ease. The problem arises when these signals are not all in the same direction in a specific period.

On the contrary, if the dollar were softening, with M1 continuing high and the business picture looking better, tighten. That's too easy when all of them are moving that consistently. I think that's what the directive ought to say, whatever the particular form: that if all these things--or the weight of them--are moving in one direction or the other, we would ease or tighten. It's perfectly reasonable.

MR. MARTIN. And you are implying a symmetrical view here, essentially, or a little on the tightening side because--

CHAIRMAN VOLCKER. Well, I see it as symmetrical in an analytic sense. My gut feeling is that it continues to--. Well, the one thing I really worry about is the dollar getting out of hand on the down side. It's--

MR. RICE. So you would be guided more by what happens in the foreign exchange market?

CHAIRMAN VOLCKER. Well, I am talking about very short-run tactics. At this moment you get the impression that we're a "captive" as some people put it, and we have to ease to get the dollar down. The dollar has come down quite a lot. I am very sensitive to the psychology going the other way, based upon all we have experienced here and abroad as to what happens sometimes when the market gets to expecting ease. Maybe everybody is ready. We will have a great test on the up side. I would much rather have a test on the up side and do a lot of intervening and maybe ease a bit, than I would a test on the down side. The upside test is much more manageable than the downside test. There is no catastrophe if the dollar gets a little stronger than it has been and we have to do a lot of intervening and we even have to ease a little. I don't see any lasting damage from that scenario, except that politically it undercuts the anti-protectionism [position] but I don't know how much weight to put on that in terms of sensitivity to day-to-day developments. It's a question of what and where. When I look at the broad strategy down the road--inflation, and all the rest--I am more worried, though I don't know which is more probable, about the risks we run from a deteriorating dollar if it got out of hand than the others. I'm not worried about the current level but I don't know how much longer [unintelligible]. I would say with all the hoopla this thing gets that there is a lot of sensitivity to this point. I see it was in the papers that there was some insistence in the G-5 meeting that they redo the language of the statement to get the word "orderly" or the wording "orderly decline or orderly rise" in there. That was a Latin American inspiration; they among others were sensitive to this point. Nobody pays any attention to it, but it reflects that concern that this could get out of hand. I'm not saying anything different here about the [borrowing] numbers than anybody else was saying. But I am suggesting some tolerance of some day-to-day, week-to-week maneuvering, influenced by the dollar but against a background of these other things.

VICE CHAIRMAN CORRIGAN. That's fine with me.

MR. PARTEE. I agree.

MR. GUFFEY. You have no problems with the funds rate beginning to trade at 8 percent or a little higher in view of the most recent background of something less than that--that is, coming out of this meeting and seeing it trade at 8 to 8-1/4 percent?

CHAIRMAN VOLCKER. Not particularly during a period when the dollar is weak. I would if the dollar were surging up; I would not under today's conditions in the market. If we were having a great test on the up side, we would not choose those days for making any tightening move. If anything, we would resolve our doubts in the other direction, if that's the direction we think we are going.

MR. GUFFEY. Well, since funds haven't traded above 8 percent in recent times, moving above 8 percent may provide a message of sorts.

CHAIRMAN VOLCKER. Well, I'm not saying we aim above 8 percent. I would accept something like, say, $500 million, which is the figure most people picked one way or another as the center of gravity. And that's where we would aim as a kind of starting point.

MR. PARTEE. And that ought to be about 8 percent?

CHAIRMAN VOLCKER. It would be 8 percent or a little below, I would guess. We don't know; we often get caught in just implementing policy during the week that things do not turn out the way we expected because of a bad projection or for some other reason. How frozen are you to pushing toward $500 million if it is above $500 million and the market is already easing or vice versa? I don't think this is a period when we want to give these day-to-day signals that may be contrary to our basic intention, in an effort to get a lower or a higher [borrowed] reserve figure because that is mechanically what we are supposed to be hitting. I guess what I am saying is that this is an operating technique. The basic point remains. We meet fairly soon, of course, for our next meeting. But if everything or the great weight of evidence was in one direction or another, these directives always call for changing the center of gravity either in an easing or a tightening direction. I say an easing or a tightening direction, but my own suspicion is that I wouldn't expect either, outside of that range I talked about. Given how high the money supply already is, given that the dollar is moving lower, given a little better feeling about the economy, I would be prepared to tighten if all those things came down in that direction. Well, I don't think we'd do anything drastic in the next 5 weeks but we could lean more consistently toward the $600 million than less.

MR. PARTEE. It is just five weeks before the next meeting?

CHAIRMAN VOLCKER. So I am told by the Secretary.

MR. BERNARD. Yes, this is the shortest interval of the year.

MR. PARTEE. Good. Good timing.

CHAIRMAN VOLCKER. Of course, we could always have a consultation in between, and I would presume we would if we were going to make a really big change. It's hard for me to conceive of--I shouldn't be so flat-footed. I should say I would be surprised if we wanted to go below $400 million or above $600 million as the center of gravity, as opposed to in a particular week in the next five weeks.

MR. BALLES. There is going to be quite a bit of difference, Mr. Chairman, between the lower end and the upper end of that range in terms of the tone of the markets.

CHAIRMAN VOLCKER. I don't know. We went from $400 to $500 million with no change in the tone of the markets.

MR. BALLES. It's a pretty wide range.

CHAIRMAN VOLCKER. If Mr. Corrigan's banks have computer problems, or at least alleged computer problems, they borrow more for a week than we do with all our open market operations.

MS. SEGER. Maybe we can sabotage computers! That would be worse.

MR. BOEHNE. They have enough potential on their own; we don't need to help!

CHAIRMAN VOLCKER. In that connection, I'll make an ad hoc comment--not about computer problems in particular. This happens mostly with a handful of very large banks: They waltz in at 5:30 on a Wednesday afternoon when the funds rate has been 7-1/2 or 7-3/4 percent all day and it gets to 9 percent at 5:30 on Wednesday afternoon and they say very conveniently "Whoops, we're in overdraft and we want to borrow from you." I think they ought to be told to go shove it.

MR. BLACK. Certainly couldn't be more descriptive!

MS. SEGER. They are just profit-maximizers.

CHAIRMAN VOLCKER. I will modify that comment; I'd tell them the next time they can go shove it. But, we have this question of the directive. What we are talking about in terms of the numbers in the directive is alternative B. I think we are saying "maintain." There is this question we need to deal with about whether we say that we expect M1 to exceed the range for the year. Obviously, that seems highly probable although less certain this minute. I don't think it's absolutely certain--highly probable but not absolutely certain--if we get a big decline in October. I think some are in favor of changing that if we are [positive]; maybe we should face up to that if we are. It raises the question of whether we should say so publicly. I haven't any very convenient occasion to do that right now; I would hate to go out and make a special announcement just on this. If we do, it lends itself directly to the interpretation that we picked this particular time to ease policy because of the exchange market situation, which I think would be unfortunate. I don't think we want to give that impression. So we're caught in a dilemma. We may face this as a fact, but it's a bit awkward. We may have a probable occurrence, but is it that much more apparent this month instead of last month, let's say, that we are compelled to make an announcement? It's almost bound to be misinterpreted, simply because it will be interpreted in the light of this exchange market.

MR. PARTEE. I think we could hold this for five weeks, Paul, by which time we will know whether October--

CHAIRMAN VOLCKER. That is certainly true, and that would take care of this announcement.

MR. BALLES. I for one would agree that this would be a bad time to make an announcement.

CHAIRMAN VOLCKER. Well, let's leave this out then. But if we are even more convinced 5 weeks from now, then we ought to decide it. Now, I'm not sure I looked at all these variants that closely, but the main theme is what: not sticking M1 in the same sentence with the others?

MR. MARTIN. I think variant II is a little more direct. It's a considerably more direct expression of what we actually have been doing, Paul, and I think it commends itself because it is direct. And it starts off with the aggregates; it doesn't leave them out.

MR. BLACK. I think it's a more accurate description of what we have been doing, but the old one gave the aggregates more primacy and I'd hate to see that lost. But I sure agree with you that it's more [descriptive of] what we've been doing.

MR. WALLICH. I like the first variant. Whether [or not] it's what we have been doing, I think it points to what we should be doing.

MR. PARTEE. I think variant II is so much more honest that we ought to--

MR. BOEHNE. Yes, we ought to take a chance and--

CHAIRMAN VOLCKER. Let me have a short recess for 15 seconds to understand what the difference is between these variants. The first sentence is the same.

MR. AXILROD. The first sentence is meant to be the same, yes. There may be typos; that's different.

CHAIRMAN VOLCKER. I guess there is no difference between them, but shouldn't it say the degree of pressure on reserve positions "sought in recent weeks"?

MR. AXILROD. Well, I assumed--

CHAIRMAN VOLCKER. Didn't we have this small change?

MR. AXILROD. Well, I assumed we hit the $500 million. In the past we have used "sought" when we didn't get what we were aiming for. But whichever way, it doesn't matter.

CHAIRMAN VOLCKER. Well, let me just see where the changes are. "This action is expected to be consistent with--"

MR. AXILROD. The next two sentences may be expressed differently, but they are meant to be the same in that there is an M2 and M3 sentence and an M1 sentence. The difference comes after that.

CHAIRMAN VOLCKER. Well, you have no differences between them in the first three sentences.

MR. AXILROD. That's right. The difference is that the "somewhat greater or somewhat lesser restraint," instead of being confined only to the monetary aggregates and viewed in the context of everything else, pertains to the monetary aggregates and everything else all the same. And there is a little change in the last sentence.

CHAIRMAN VOLCKER. We're combining in one sentence what we said in three sentences.

MR. AXILROD. Yes, that's right.

MR. BLACK. I think people would read that second variant as saying that we are targeting nominal GNP, which is what I'm afraid we're doing. I wouldn't want to be accused of dishonesty, since Chuck said this is more honest, but--

MR. PARTEE. [Unintelligible] the exchange rate too.

MR. BOEHNE. The aggregates are listed first in the sentence.

MR. BLACK. Yes, but they sure are downgraded from where they were.

CHAIRMAN VOLCKER. Well, I think one can exaggerate the difference between these two variants. The fact is that the second one is somewhat less cumbersome.

MR. BLACK. That's what markets do when we change--

MR. AXILROD. I took the words "monetary objectives and related reserve paths" out of the last sentence and substituted "reserve conditions" since that's what the Manager is operating on.

VICE CHAIRMAN CORRIGAN. It says you're going for them.

CHAIRMAN VOLCKER. Well, it seems to me either of these versions ought to say "sought in recent weeks" in sentence number one since we did change it, however modestly, during the last period. And we're talking about "maintain" I think. What are we putting in here in either version? What do we say--

MR. PARTEE. 6-3/4 percent.

CHAIRMAN VOLCKER. 6 to 7 percent? Is that--

VICE CHAIRMAN CORRIGAN. That's fine.

CHAIRMAN VOLCKER. Annual rates of "about 6 to 7 percent" or "6 to 7 percent"? With 6 to 7 percent, does anybody want an "about" or "around" in there?

MR. MARTIN. Use "about," in case we get lucky.

CHAIRMAN VOLCKER. "About 6 to 7 percent" for both of them.

VICE CHAIRMAN CORRIGAN. Yes.

CHAIRMAN VOLCKER. "M1 growth is expected to slow--." Heavens, I don't know whether it is going to slow.

MR. PARTEE. No, it's expected to slow and then--

MR. MARTIN. 6-1/2 percent in "B."

MR. KEEHN. Do we really want to say a marked slowing of M1 growth is expected?

SPEAKER(?). Sure.

CHAIRMAN VOLCKER. It leaves it plenty open there.

MR. BOEHNE. That's variant II.

MR. FORRESTAL. That's variant II.

MR. PARTEE. It's certainly "marked" compared to where it has been.

MR. MARTIN. Down 11 or 12--

CHAIRMAN VOLCKER. My version doesn't say anything about marked.

SPEAKER(?). I think it's in variant II.

SPEAKER(?). I thought you wanted variant II.

MR. MARTIN. In variant II, it's the sixth line from the top.

VICE CHAIRMAN CORRIGAN. He's on variant I.

CHAIRMAN VOLCKER. Oh, I'm sorry. Okay.

MR. KEEHN. Couldn't we say something like "It's entirely possible that M1 growth might slow"?

MR. BOEHNE. But then again it may not.

MR. BLACK. On the one hand, we hope so but--

CHAIRMAN VOLCKER. Okay, I guess we really are expecting a marked decline.

VICE CHAIRMAN CORRIGAN. Yes.

MR. PARTEE. Even 11--

MR. BLACK. Even I think it will be a marked decline.

CHAIRMAN VOLCKER. What do we want to say here: 6 to 7 percent or something? Everything is 6 to 7 percent.

VICE CHAIRMAN CORRIGAN. It will be all right or all wrong.

CHAIRMAN VOLCKER. We took out this sentence. What do people think about that? "Slower growth would be appropriate--"

SPEAKER(?). "Would be acceptable."

VICE CHAIRMAN CORRIGAN. "Acceptable."

MR. PARTEE(?). It would be acceptable to me.

MR. RICE. I agree.

CHAIRMAN VOLCKER. You want to put it back in?

VICE CHAIRMAN CORRIGAN. It applies to M1?

CHAIRMAN VOLCKER. Yes, just M1.

VICE CHAIRMAN CORRIGAN. I kind of like that, if the word "acceptable" were put in place of "appropriate."

MR. AXILROD. We meant that to apply to both variants; that was the--

CHAIRMAN VOLCKER. It would have a semicolon or something. Let me ask you the question: I wouldn't say "even"--

MR. PARTEE. I wouldn't either.

CHAIRMAN VOLCKER. So it's "slower growth over the next three months would be acceptable"--

VICE CHAIRMAN CORRIGAN. Yes.

CHAIRMAN VOLCKER. --"in the context of satisfactory economic performance." Do you want that phrase "given the recent rapid growth" in?

VICE CHAIRMAN CORRIGAN. I like it.

CHAIRMAN VOLCKER. I'm not hearing any dissents on that, so that phrase goes in either version. Now, we have "somewhat greater or lesser reserve restraint would be acceptable" with a number of alternatives here. Who prefers variant II?

MR. MARTIN. It's more direct.

CHAIRMAN VOLCKER. Only two people, Governors Martin and Seger. Add Governor Partee.

MR. PARTEE. Well, "somewhat greater or lesser reserve restraint" is in both of them.

CHAIRMAN VOLCKER. Well, I'm just skipping from that to simply who wants to combine three sentences into one sentence.

VICE CHAIRMAN CORRIGAN. I'm indifferent.

CHAIRMAN VOLCKER. Mr. Keehn, did you have your hand up?

MR. KEEHN. No, I'm having a very difficult time determining the differences between these two.

CHAIRMAN VOLCKER. I'll rephrase it. I would declare there is no difference in substance, as near as I can see. But the change is considered by some, and I think it's probably true, more accurate and a better [representation of] what we're actually doing.

MR. MARTIN. It's certainly more economical.

MR. KEEHN. I think that might be fine. But I really do have a bit of a problem with this phrase, "marked slowing of M1 growth" in variant II.

VICE CHAIRMAN CORRIGAN. That's out.

CHAIRMAN VOLCKER. No, no. It's in.

VICE CHAIRMAN CORRIGAN. Oh, that's right. Yes, that is in.

CHAIRMAN VOLCKER. Why are you troubled with that?

MR. KEEHN. I suppose what you're saying is that even if it goes from 20 percent to 15 percent, 5 percent is a significant amount. But that, I think, has a kind of improper implication. I just think it would be better if we were a bit vaguer on that, say, "It's entirely possible that M1"--

MR. BALLES. Mr. Chairman, one reason for taking variant I is that the Fed watchers are going to be looking for the slightest clue that we're somehow stuck or are precluded from tightening up or even are on an easier money kick. For the very reason that you didn't want to change the announced ranges for the second half of the year, I would argue against moving away from that traditional language, even though there may be a more accurate [description] of what we're doing.

CHAIRMAN VOLCKER. Well, I think that's a fair consideration. I'm not sure they can read too much into this except less emphasis on the aggregates. What do you have besides the [unintelligible] variant II? I'm not hung up on this because we've gone too many months in which there has been the proviso that [unintelligible] has been operative since 1979.

VICE CHAIRMAN CORRIGAN. But if we have that sentence that says "a marked slowing in M1 growth to a 6 percent annual rate is anticipated" with the clause that says "somewhat more of a slowdown would be acceptable," technically that finesses not having to announce abandoning the ranges here either because it leaves open that possibility. So I think that we need both the sentence and the semicolon phrase or else we're really cheating on not saying anything about the paragraph that we already agreed [not to consider] until five weeks from now.

CHAIRMAN VOLCKER. Well, I asked how many preferred variant II. Maybe a lot of people are neutral here. How many have a distinct preference for variant I? [Secretary's note: Messrs. Balles and Black.] About as many votes as for variant II. How many--

MR. BLACK. How many people don't give a whit?

CHAIRMAN VOLCKER. That's another way. How many people don't care? That's a majority.

MR. BOEHNE. The Chairman's choice.

MR. BLACK. I think John Balles has a good point on the market's reaction to any change. Partly I think it's a good point because I tried to make that same point earlier and--

MR. PARTEE. You were the two who held up your hands.

MR. MARTIN. I think it's better to say to the market what they already know we're doing rather than hang on to what [unintelligible] short-run picture.

CHAIRMAN VOLCKER. I must say that at this point it doesn't make any difference to me. I guess I'm with all those who stuck up their hands in the middle, but I--

MR. RICE. Let's have a variant III.

MR. MARTIN. Credibility is something of believability. Why not say what is?

VICE CHAIRMAN CORRIGAN. This is subject to the interpretation of--

CHAIRMAN VOLCKER. We need one of those fancy electronic gadgets that people can squeeze so they can measure the intensity of feelings.

VICE CHAIRMAN CORRIGAN. Long term, we've advanced from pragmatic monetarism to full-blown eclecticism.

MR. BLACK. Maybe we can weight the votes by the intensity of the feeling and come up with an algebraic average of it.

CHAIRMAN VOLCKER. Well, that's what I'm trying to do. Who feels intensely about this? [Turning to Mr. Black] You're going to vote against this, anyway, so--

MR. BLACK. Well, Mr. Chairman, this is an argument I don't want to win, obviously, because if I'm right we have done the wrong thing. My objective is to do the right thing. So I hope I'm wrong. Usually I don't hope I'm wrong on arguments, but I do on this one.

CHAIRMAN VOLCKER. Well, okay. Just let me get an expression --I realize it's no big deal--[of preferences]. How many would have some preference for I? One, two, three, four. [Secretary's note: Messrs. Balles, Black, Forrestal and Rice.] How many would have some preference for II? Four. [Secretary's note: Messrs. Keehn, Martin, Partee and Ms. Seger.]

MR. PARTEE. You get to decide it.

CHAIRMAN VOLCKER. Maybe I should read it more carefully.

MR. PARTEE. He acts this way when the Board splits on something!

VICE CHAIRMAN CORRIGAN. I've observed it myself once or twice, Governor Partee.

MR. BLACK. Run it by Joe Coyne and let him tell you how the news media would or could react, and I guess--

MR. COYNE. I don't think they'll see any difference.

MR. BLACK. Well, hush! That's the wrong answer!

VICE CHAIRMAN CORRIGAN. But you have to understand that the staff spent all day Thursday and Friday making these variants look different!

MR. MARTIN. Until we've made them look the same.

CHAIRMAN VOLCKER. Do you have any comment about this subject, Mr. Axilrod?

MR. AXILROD. Well, Mr. Chairman, a technical reading of the first variant says that the Committee will tighten or ease depending on what happens in the aggregates and they'll assess that in the context of the other things. The only slight substantive difference I can see is that a technical reading of the second variant says you could tighten or ease even if the aggregates were on track, depending on what happens to other things. I think that's what the Committee pretty much has been doing recently and this was just a sentence that attempted to say that. You have to stretch your reading of the first variant a bit to have that in, but of course it encompasses it. The only other difference was that in the last sentence it says "pursuit of the monetary objectives and related reserve paths during the period before the next meeting is likely to be associated with a funds rate..." and I short-circuited that to just "reserve conditions" because the monetary objectives were cast in with other things--for obvious reasons.

CHAIRMAN VOLCKER. Well, I just thought of adding three words here that make them maybe exactly the same, but more condensed. Leave it variant II, but after the first comma--after "depending on the behavior of the aggregates" add "taking account of" before "appraisals of the strength in business expansion, developments in foreign exchange markets," etc.

MR. BALLES. That would be better.

CHAIRMAN VOLCKER. Does that strike anybody as an improvement?

VICE CHAIRMAN CORRIGAN. Sure. Yes, I think it does.

MR. RICE. Right; that takes care of it.

CHAIRMAN VOLCKER. All right. Let's just do it that way. Add these words "taking account of." Does that make it--

MR. PARTEE. That does make it very much like the first variant.

CHAIRMAN VOLCKER. And then for the federal funds rate I guess we're sticking with 6 to 10 percent, right?

VICE CHAIRMAN CORRIGAN. But you have that phrase in there that says that "slower growth of M1 is acceptable"?

CHAIRMAN VOLCKER. Yes. What we have is take out the word "existing" and say "maintain the degree of pressure on reserve positions sought in recent weeks."

VICE CHAIRMAN CORRIGAN. Right.

CHAIRMAN VOLCKER. "This action is expected to be consistent with growth in M2 and M3 over the period from September to December at annual rates of 6 to 7 percent. A marked slowing in M1 growth to a 6 to 7 percent annual rate is also anticipated; slower growth over the next three months would be acceptable"--not appropriate, but acceptable--"in the context of satisfactory economic performance, given recent very rapid growth in M1. Somewhat greater or lesser reserve restraint...." That's right, we didn't discuss that. Do we just leave in the somewhat greater or lesser reserve restraint respectively?

VICE CHAIRMAN CORRIGAN. Yes.

CHAIRMAN VOLCKER. Okay, take out the parenthetic phrase and continue: "Somewhat greater or lesser reserve restraint would be acceptable depending on behavior of the aggregates, taking account of appraisals of the strength of the business expansion, developments in foreign exchange markets" and so forth. Then "The Chairman may call for consultation if it appears that reserve conditions...are likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent." Now, I take it that's a common denominator. We have this little discretion of day-to-day or week-to-week operational flexibility around $500 million influenced--not solely--but influenced by exchange market problems in the context of these other developments. And certainly, if we were really aiming in a semi-permanent way as high as $600 million or as low as $400 million--as opposed to a weekly decision to go to one of those numbers--we would just have a consultation. Understood? I guess we can vote.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
President Balles	Yes
President Black	No
President Forrestal	Yes
President Keehn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. Okay, thank you. I guess we're finished. We meet again in five weeks. Lunch is over in the other building.

MR. BERNARD. Dining Room F.

END OF MEETING